BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI.

Statement.

Reference to the opinion below, a statement of the grounds upon which the jurisdiction of the Court is invoked, and a statement of the case, under appropriate headings, are set out in the foregoing petition, and to avoid duplication are not repeated here.

ARGUMENT.

Summary of Argument.

For the first ten months of the taxable year, petitioner was subject to a mortgage, as amended, concededly a valid restrictive covenant under Section 26 of the Revenue Act of 1936, whereby—

(a) It was specifically forbidden to declare dividends until it had paid large sums of accrued interest and sinking fund obligations under the original mortgage, and

(b) It was currently required to make a sinking fund payment to the mortgage trustee for every ton of coal mined.

As required by the mortgage, it made payments in varying amounts during the first ten months of the taxable year, of an aggregate in excess of its net income. Such constituted an irrevocable payment of its net income, as it is stipulated that, prior to the release of the mortgage it did not, and could not, make and did not have funds or income, either accumulated or accrued, sufficient to make the payments which were required as a condition precedent to any dividends.

The mortgage was released on November 1 of the taxable year and, accordingly, for the last two months thereof no contractual inhibition as to dividends was currently in effect.

Such circumstance does not justify, however, the imposition of an undistributed profits tax upon a basis of the whole net income for the year as disclosed by the books, because—

(a) Such is only a book income, the actual income, and the source of payment of any dividend, having been previously distributed by contractual compulsion.

(b) The words "can be distributed" occurring in the statute will be interpreted according to their natural and ordinary meaning and not according to theoretical bookkeeping concepts.

(c) The statute will be interpreted so far as possible to avoid unjust or unreasonable consequences. To deny a credit with respect of income so distributed would lead to such consequences because—

1. There would be a heavy penalty upon this taxpayer in relation to other taxpayers who have had restrictive contracts released at a more favorable time in a taxable year, or were upon a more favorable fiscal year basis—fortuitous circumstances wholly disassociated from the realities of tax status.

2. To deny such credit is in effect to make the release of November 1 retroactive to the first of the year, thereby distorting the realities of the situation, and depriving it of any effect during the year, even though actually taxpayer was bound to act under its requirements for ten months of that period.

The sinking fund requirement that a tonnage payment be made for each ton of coal mined dealt with earnings and profits, and payments made thereunder entitled petitioner to a credit under Section 36(c) (2) of the Act of 1936. Such

is true even though the mortgage referred to "coal mined," and not "coal mined and sold" because—

(a) If coal were mined and not sold, the value of such unsold coal would go into inventories, and would be included in, and affect, earnings and profits to the same extent, and in the same manner, as if sold, and

(b) As a matter of natural interpretation, and practical necessity, the mortgage contemplates sale, as well as mining of product, and in the year in question there were more than $1,000,000 in sales.

There is accordingly an irreconcilable conflict between the decision of the Circuit Court of Appeals in this case and that of the Circuit Court of Appeals of the Sixth Circuit in *Michigan Silica Company* v. *Commissioner,* 124 Fed. (2d) 397.

Issue Under Section 26(c)(1) of the Revenue Act of 1936.

Section 26(c) (1), in fixing the basis for credit against the undistributed profits tax refers to amounts "which can be distributed," without violating a provision of a written contract expressly dealing with the payment of dividends. Section 26(c) (2) gives credit for the portion of the earnings and profits of the taxable year, which is required by a restrictive contract, to be paid within the taxable year in discharge of a prior debt. There is here no question but that the mortgage expressly referred to dividends, and it was conceded in the court below by respondent, and doubtless will be conceded, that such mortgage as amended was a valid and restrictive contract until it was released. It is stipulated that at no time until such release did the petitioner have any funds or income, either accumulated or accrued, sufficient to make the various payments required by the mortgage as a condition precedent to the payment of any dividends.

There is likewise no dispute that the sinking fund provisions of the mortgage were in effect during the year 1937, and that there was paid under them in varying amounts to the Corporate Trustee the sum of $71,868.79 (R. 13), a sum in excess of the net income. In addition to these payments, $26,335.98 was also paid to the Trustee prior to November 1, 1937 (R. 13). These payments are stipulated as having been made "as required" by the mortgage and modifications thereof (R. 13).

The Court below states (R. 37) that the taxpayer has not shown that these payments were actually the proceeds of earnings or profits, and that at least to some extent they must have been made from other sources, as the aggregate payments exceed net income. With every deference to the Court, it is respectfully submitted that it failed to give effect to that part of the stipulation appearing in the record, on page 11, to the effect that until the release of the mortgage the petitioner *did* not, and *could* not, make, and did not have *funds* or *income*, either *accumulated* or *accrued,* sufficient to make the payments required as conditions precedent to declaration of dividends. These payments were made under compulsion of the modified mortgage, and the stipulation is a comprehensive negation of the existence or possibility of any extraneous funds other than income, or other funds beyond the payments actually made. It would, of course, have been possible to have stipulated specifically that petitioner did not have funds from extraneous sources which would have permitted it to make these payments, thus leaving income intact, such as from capital contributions, reserves, or the like, and such would certainly have been the fact, but it would be impossible to embrace all the theoretical sources from which a corporation might have received money. It might receive insurance proceeds upon the life of an officer; it might be awarded damages in a tort action; it might conceivably find

money. It would be impossible to stipulate against every possibility of this kind otherwise than in general terms, and here the stipulation is in the most definite and comprehensive terms that it did not have "funds or income," either accumulated or accrued, of an extraneous character. The stipulation was intended as a comprehensive negation —and, it is respectfully submitted that it is such—of the existence or possibility of any extraneous funds. It follows that the payments that were made to the Trustee represented the receipts of the current income to the extent of that income, and represent all other available money. Otherwise, the comprehensive stipulation of the absence of any other funds or income would be nugatory. Therefore, counsel respectfully submit that it is undeniable that the payments made to the Trustee were made (a) under the compulsion of the mortgage, and (b) those payments necessarily included the net income received during the first ten months of 1937.

There is no question that such payments were irrevocably and finally made, it being stipulated (R. 14) that these funds were all distributed by the Trustee, as required by the mortgage. In passing, it may be noted that the Circuit Court of Appeals states (R. 37) that the sinking fund payments were for the purpose of reducing taxpayer's debt; that they were capital expenditures, were not expense payments which would have been deductible from income, the Court evidently overlooking (R. 14) that these payments were applied by the Trustee to the extent of \$42,840.00 for the retirement of bonds, \$39,171.10 for interest accrued prior to 1937, and \$16,782.84 accrued during the year 1937. Very much more than half thereof were for interest payments which were either deductible in the current year or accrued and unpaid in prior years. It cannot be gainsaid that actually the income for the first ten months upon the date of the release of the mortgage

had passed out of the treasury of the corporation, and had actually been distributed under contractual compulsion. Is this income, previously distributed, such as "can be distributed" when the mortgage is released? It is true that, as a matter of bookkeeping, a net income appears on the books of the corporation at the end of the year, but such is merely a book entry. The actual fact is that the money represented by that income has previously been distributed.

The Circuit Court of Appeals bases its decision upon the accounting concept (R. 37, 38) that the books showed a net income at the end of the year, regardless of the payments previously made, that the Court is concerned only with the question whether taxpayer was contractually permitted to distribute profits at any time during the year 1937 and, because during the last two months of the year there was no contractual inhibition and the books for the year showed a net income, taxpayer theoretically was able to declare a dividend. Nowhere in the record is it shown that as a practical matter it could have declared a dividend. When it was relieved from its contractual obligation, its income had been distributed under the requirements of the contractual obligation. It had an enormous deficit both at the beginning and at the end of the year, the latter, even reduced by its net income for 1937, amounting to $372,958.36 (R. p. 12). If such a corporation had been able to go out and borrow enough money to declare a dividend equivalent to its whole net income for the year, a supposition most unlikely, certainly legally it was not required so to do. A dividend is a very real thing: it is not a matter of bookkeeping. It must be paid from an actual source; it cannot be paid by book entries. Here the only source from which such dividend could be paid had been wiped out under the contract before its release. There was positively and literally no way by which a dividend could actually have been paid.

The inability of the taxpayer to pay the dividends cannot be denied by the *actuality* of the situation. Certainly, Congress when it used the words in the statute, "can be distributed," must have meant the plain, common sense, and actual meaning of those words. The purpose behind the undistributed profits tax was to require the distribution of available earnings by dividends that would be taxable to the recipient stockholders, and certainly the situation of the taxpayer is not within the contemplation of Congress. A corporation with a huge deficit, which actually distributed under contractual compulsion its income as received, with absolutely no funds in its treasury which would permit the distribution of a dividend, certainly is not within the intent of Congress as the subject of taxation. Its situation was beyond the purview of the statute, which surely did not have the purpose of requiring through theoretical bookkeeping concepts, that which was practically, actually and realistically impossible. To say, under such circumstances, that the petitioner could have paid a dividend out of earnings that had previously been disbursed, and thereby obtain a dividend-paid credit, or to say that the subsequent release could affect a prior, actual and irrevocable payment, is to be utterly unrealistic. Perhaps the most significant development of tax law in the last few years has been the most commendable trend, evidenced by both the decisions of the Courts and the Board, to regard a tax situation from the actual and practical viewpoint, and not upon mere theories of accountancy. This trend has been forcibly shown by Mr. Justice Reed, speaking for this Court, in the recent opinion of *Higgins* v. *Smith*, 308 U. S. 473, 84 L. ed. 406, in which he said (Italics ours):

> "There is no illusion about the payment of a tax exaction. Each tax, according to a legislative plan, raises funds to carry on government. The purpose here is to tax earnings and profits less expenses and

losses. *If one or the other factor in any calculation is unreal, it distorts the liability of the particular taxpayer to the detriment or advantage of the entire taxpaying group.*"

It would be impossible to visualize a situation more distorted from actuality than to impose a tax upon so-called undistributed profits, which profits actually had been irrevocably paid out under the requirements of a pre-existing mortgage, or to assume that a taxpayer should have declared dividends in the last two months of a taxable year out of funds that were no longer in its treasury and could not have been retained in such treasury. As said in *Shoenberg* v. *Commissioner* (C. C. A. 8th), 77 Fed. (2d) 446, "taxation is concerned with realities." How far the courts go in looking to the actual situation in tax matters, even where it is necessary to brush aside legal technicalities and concepts (such is not here necessary) appears from the following cases:

Gregory v. *Helvering,* 293 U. S. 465;
Helvering v. *Security Savings & Commercial Bank,* 72 Fed. (2d) 874 (C. C. A. 4th);
Helvering v. *Elkhorn Coal Co.,* 95 Fed. (2d) 732, (C. C. A. 4th);
Commissioner v. *Dashiell,* 100 Fed. (2d) 625, (C. C. A. 7th).

The language of Section 26(c) (1) refers to "amounts which can be distributed within the taxable year as dividends," etc. The stipulation, almost in the same words, negatives such ability. The restrictive writings were executed and effective prior to the 1st day of May, 1934, and (italics ours) "upon said day, and at all times thereafter, petitioner had not met, and *was unable* to meet, the conditions therein set out, precedent to the payment of dividends." (R. 11.) Of course, the complete correspondence between the verb "can" and the expression "is able,"

with its negative "unable," is apparent. Here the stipulation specifically parallels the words of the statute in showing an inability to make a distribution, which the statute provides "can be distributed" before the tax is imposable. Words in a statute must, of course, be given their ordinary meaning unless some technical definition be provided. This Court in *Helvering* v. *Northwest Steel Rolling Mills*, 311 U. S. 46, committed itself to the natural or common sense interpretation of the words of the statute. There the taxpayer was forbidden by the law of the state of its incorporation to declare a dividend because of a pre-existing deficit. The question was whether such legal inhibition was to be read into the corporate charter, and the latter accordingly interpreted as a written contract prohibiting dividend payments. The Court recognized that in certain circumstances a corporate charter had been judicially construed as a contract and that it had been said that the act of incorporation was a contract between the state and the stockholders. However, the Court in giving the natural, common sense interpretation of the statute said, in the course of the opinion:

> "The natural impression conveyed by the words 'written contract executed by the corporation' is that an explicit understanding has been reached, reduced to writing, signed and delivered."

In the present instance, it conclusively appears that, as a matter of reality, petitioner could not have distributed a dividend measured by its total income because of prior distribution under the requirements of the mortgage. It had nothing from which such dividend could be paid. Certainly the "natural" meaning of the words "can be distributed" must be attributed to Congress, which was certainly dealing with actual ability, not a theoretical bookkeeping status.

As stated by this Court in *Old Colony Railroad Co.* v. *Commissioner,* 284 U. S. 552, 76 L. Ed. 484, on page 560 of the opinion:

> " 'The legislature must be presumed to use words in their known and ordinary signification.' Levy *v.* M'Cartee, 6 Pet. 102, 110, 8 L. ed. 334, 337. 'The popular or received import of words furnishes the general rule for the interpretation of public laws.' Maillard *v.* Lawrence, 16 How. 251, 261, 14 L. ed. 925, 930. And see United States *v.* Buffalo Natural Gas Fuel Co., 172 U. S. 339, 341, 43 L. ed. 469, 470, 19 S. Ct. 200; United States *v.* First Nat. Bank, 234 U. S. 245, 258, 58 L. ed. 1298, 1303, 34 S. Ct. 846; Caminetti *v.* United States, 242 U. S. 470, 485, 61 L. ed. 442, 452, L. R. A. 1917F, 502, 37 S. Ct. 192, Ann. Cas. 1917B, 1168. As was said in Lynch *v.* Alworth-Stephens Co., 267 U. S. 364, 370, 69 L. ed. 660, 662, 45 S. Ct. 274, 'the plain, obvious and rational meaning of a statute is always to be preferred to any curious, narrow, hidden sense that nothing but the exigency of a hard case and ingenuity and study of an acute and powerful intellect would discover.' This rule is applied to taxing acts: De Ganay *v.* Lederer, 250 U. S. 376, 381, 63 L. ed. 1042, 1044, 39 S. Ct. 524."

It was argued below and the position was adopted by the Circuit Court of Appeals that if at any time during the taxable year the taxpayer was free from the contractual inhibition as to any dividends—and it was free during the last two months—then under the statute it should not be given credit for money paid out during the period when it was under contractual inhibitions and requirements, and that any actual inability to declare a dividend in the last two months of the year arose from the prior use of money and not from a contractual inhibition. It is respectfully submitted as inescapable that such prior use of money was, and such is stipulated, as required by the contract. It follows as the night the day that inability to declare a divi-

dend in the last two months arose from the restricted contract because the actual distribution of the income had been made under its requirements. To give retroactive effect to the release of November 1, 1937, so as to make it operative during all of the year and to remove from its protective provisions the whole income for the year is not only to close one's eyes to actuality, but to deny any effect to the admittedly valid restrictive contract during the period in which it was in effect.

It will perhaps make for clarity, if it be visualized that the petitioner, instead of being relieved by the voluntary exchange of notes for stock by the noteholders, had obtained release of the mortgage through the complete satisfaction of the indebtedness secured. There have been innumerable mortgages satisfied through payments to the trustee under restrictive contracts, such as that admittedly here present during the first ten months of the year. In virtually all of such instances the mortgage is satisfied during a taxable year. It would be improbable that such satisfaction would happen exactly at the end of a year. Doubtless in 1937 there were countless mortgages satisfied during the course of the year through application of sinking fund payments, parts of which were made during that year. Shall it be said that in every such instance the restrictive covenants of a mortgage, however stringent they might be, become ineffective as of the first of the year? Every corporation, unless it happened by a long chance to satisfy its mortgage at the exact end of, or just beyond the taxable year, would be heavily penalized during the years of the incidence of the undistributed profits tax law. Assume a corporation prior to May 1, 1936, had borrowed money under a mortgage which required it to apply all of its current net income to the satisfaction of the debt, forbidding dividends until the debt was so satisfied—provisions within both sections of the statute as was here the case—and the money was so

applied, with the result that on December 20, 1937, the debt was finally paid and the mortgage released. Could such corporation have declared a dividend of all of its net income for 1937? The voluntary release here by the noteholders on November 1, 1937, has precisely the same effect as though the mortgage were satisfied on that date.

Let us assume two mortgages with valid restrictive covenants, both of which required all income to be applied to the secured indebtedness and that one happened to be satisfied by application of such income on December 15, 1937, the other on January 15, 1938. Under the holding in this case there would be a tremendous difference in tax. Assume also that the taxpayer, as might very well have been the case, instead of being on a calendar year basis had been on a fiscal year basis ending on October 31. Taxpayer during the first ten months of 1937 could doubtless have obtained permission to go upon such a fiscal year basis. Such would be a circumstance entirely fortuitous and wholly unrelated to the realities of the tax situation here present, which would actually have been the same. However, under the decision of the Circuit Court of Appeals there would have been then no question that taxpayer would have received the protection of the restrictive contract, and there would have been no deficiency.

Sections 26(c)(1) and (2) of the Act give credits in reduction of the tax imposed by Section 14. These subdivisions, as counsel most fully admit, are subject to strict construction. Deductions and credits as against a generally imposed tax are matters of legislative grace, and the statutes conferring them should be strictly construed. However, this is not a question of strict or liberal construction. It is a question whether the words of the statute "can be distributed" and similar words are to be given their ordinary, natural meaning or whether they are to be construed without relation to actuality upon theoretical bookkeeping

concepts. As heretofore stated, this Court in *Northwest Steel Rolling Mills* has committed itself to the "natural" interpretation of Section 26(c)(1).

In no event would the rule of strict construction, if it were involved, ever be extended to justify an inherently unjust and unreasonable interpretation or one leading to unjust results, such being said with entire deference to the position taken by counsel for respondent and to the decision of the lower court. Unreasonable interpretations of a statute are to be avoided, as are, so far as possible, unjust consequences.

Constantine v. *United States* (C. C. A. 5th), 75 Fed. (2d) 928, affirmed, 296 U. S. 287, 80 L. Ed. 233;

Farmers Loan & Trust Co. v. *Minnesota,* 280 U. S. 204, 74 L. Ed. 371, 65 A. L. R. 1000.

As said by this Court in *United States* v. *Kirby,* 7 Wall. 482, 19 L. Ed. 278:

> "All laws should receive a sensible construction. General terms should be so limited in their application as not to lead to injustice, oppression, or an absurd consequence."

See also *Oates* v. *First National Bank,* 100 U. S. 239, 25 L. Ed. 580; *United States* v. *Chase Securities Co.,* 24 F. (2d) 500, certiorari denied, 277 U. S. 600.

If the statute were given the interpretation of the Circuit Court of Appeals, it is obvious:

> (1) Actually the taxpayer could not have distributed a dividend equivalent to its total income for 1937, because of the sums which it had irrevocably distributed in accordance with the restrictive contract, when the latter was in effect during the first ten months of the year;
>
> (2) To impose a tax upon its theoretical book income because it had failed to declare dividends (the income

actually having been previously distributed) would be to tax the petitioner because it could not accomplish the impossible;

(3) Such a tax would impose upon it a heavy penalty in relation to corporations which are relieved from restrictive contracts at more favorable times during the taxable year or happen to be on a favorable fiscal year basis—fortuitous circumstances completely disassociated from the actual tax situation here present; and

(4) Petitioner made payments during the first ten months of the year, *as required by the mortgage,* and if a retroactive effect were given to the release the benefit of the restrictive contract, in spite of its compulsory requirements which had been acted upon, would be withdrawn from taxpayer.

Issue Under Section 26(c)(2) of the Revenue Act of 1936.

The interpretation of Section 26(c)(2) also is governed, as taxpayer submits, by the principle, heretofore discussed, that a statute will be construed in accordance with the ordinary meaning of the words used, and, if possible, to avoid unjust and unreasonable consequences. In the discussion under this subdivision, it must be remembered that whether or not the sinking fund provisions of the mortgage be interpreted as dealing with earnings and profits, they were admittedly compulsory and binding upon the taxpayer, and the payments made were as required by the mortgage. Therefore, under subdivision (c)(1), in view of the stipulation, taxpayer was not only *prohibited from payment of dividends,* but was *required* to make payments under the mortgage as a condition precedent to a declaration of dividends, and until the release of the mortgage had insufficient funds either accumulated or accrued to make such payments (R. p. 11). However, it is most respectfully and earnestly contended that the sinking fund provision con-

stituted a disposition of earnings and profits within the meaning of Section 26(c)(2) of the Act. The mortgage required a tonnage payment for each ton of coal mined. The opinion of the Circuit Court of Appeals states that such was an agreement to pay a fixed sum, even though there were no earnings or profits, and even though the coal mined was not actually sold. The record, of course, shows that in the year in question there were gross sales in the amount of more than one million dollars (R. p. 19). Does this sinking fund provision imposing a current payment for each ton mined, deal with earnings or profits? Counsel confess that they are unable to grasp the significance of the distinction between *coal mined* and *coal sold*. While as a practical matter such would be impossible, suppose that taxpayer had mined its coal and had sold no part of it. *Its inventory of coal on hand would be increased and that increased inventory would go into its income statement.* Every corporation engaged in selling merchandise or products virtually always has income represented by increased inventory of products on hand, and if this taxpayer had large stocks of coal unsold, the increased inventory would go into its statement of earnings and profits, whether the product was actually sold or not.

Section 22(c) of the Revenue Act of 1936 (as well as corresponding provisions of other Acts) requires use of inventories whenever in the opinion of the Commissioner, such is necessary clearly to determine income, and taxpayer is within that provision and, *a fortiori*, would be bound by it if there were any considerable unmined coal at the end of a year. On page 5 of the return of taxpayer for the year in question, filed before the Board in this proceeding, appears an item of inventories in the amount of \$25,818.92, and while it is not broken down, it would be presumed to, and would necessarily include, unsold product on hand. As a matter of fact, counsel are informed by the

accountant of taxpayer, that such item does include unsold coal on hand, the value of which has always been reflected upon tax returns of taxpayer, although included in a general item of inventories. *Therefore, a tonnage payment for each ton of "coal mined" deals with earnings and profits to the same extent as if it were for each ton "mined and sold" because, if coal be not sold, its value goes into inventory, and is reflected in the income status, with precisely the same effect as if it had been sold.* As a practical matter, however, it would be impossible for a coal corporation to accumulate without selling any considerable stock of coal, and certainly "coal mined" as used in the mortgage would impute coal sold. Can it be imagined that a corporation would mine a large amount of coal and let it pile up on the ground, or that it could do so either from the physical or commercial viewpoint? The payments in the mortgage were tonnage payments, and as such were paid from the current sale of the coal that was mined, and such is also the inescapable legal conclusion. The only ground of distinction between the decision of the Circuit Court of Appeals (6th Circuit) in *Michigan Silica Co.* v. *Commissioner,* 124 F. (2d) 397, affirming per curiam the same entitled case, 41 B. T. A. 511, is that the sinking fund there was for a tonnage cement "produced and sold", while here the tonnage is only upon "coal mined". Unless that distinction be valid, there is an irreconcilable conflict between the decisions of the two Circuit Courts of Appeal. Certainly, such a distinction is not valid, because (a) if coal had been mined by taxpayer and not sold, its inventory would have been increased and that increased inventory would have gone into its statement of earnings and profits to the same effect as though there had been an actual sale; and (b) it would necessarily follow that by the mortgage the sale of the coal and not the mere production of the coal was contemplated, such being borne out by the sales during that

year of more than a million dollars. That this distinction was not recognized by the Board of Tax Appeals appears from the case of *Saginaw Manistee Lumber Co.* v. *Commissioner*, 45 B. T. A. 780, where a sinking fund provision for a unit payment upon lumber "sold or used" was held within the reasoning of the *Michigan Silica* case.

In this phase of the case, therefore, it is most respectfully submitted that the circumstance that the mortgage here provides for a tonnage payment upon "coal mined" does not differentiate it from the mortgage considered in the *Michigan Silica* case—the absence of specific reference to sale being immaterial for the reasons heretofore set forth, and there is accordingly an irreconcilable conflict in the decision in this case, and that of the Circuit Court of Appeals of the Sixth Circuit in the *Michigan Silica* case.

Conclusion.

It is respectfully represented that this is a case in which the Court, in its sound judicial discretion, may appropriately grant the writ of certiorari as prayed, and that the petition and the brief in support thereof present special and important reasons therefor.

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